

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Greene and Johannessen Analyst: Jeani Brent Bill Number: SB 974  
Related Bills: AB 638 (1997-98) Telephone: 845-3410 Amended Date: 08/13/98  
Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** Enterprise Zone/McClellan Air Force Base

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED \_\_\_\_\_ STILL APPLIES.

☒ OTHER - See comments below.

### SUMMARY OF BILL

Under the Government Code, this bill would require the Trade and Commerce Agency (TCA) to designate a portion of McClellan Air Force Base as an extension of the Northgate Enterprise Zone. The designation would be binding for 15 years. All tax incentives available to enterprise zones would be available to businesses operating in the expanded portion of the Northgate Enterprise Zone.

### SUMMARY OF AMENDMENT

The August 13, 1998, amendments removed the bill's prior provisions, which related to education, and replaced them with the provisions discussed in this analysis.

### EFFECTIVE DATE

This bill would be effective January 1, 1999, and the tax incentives would apply to transactions (such as the purchase of qualified property) on or after the date the enterprise zone extension is designated.

### PROGRAM BACKGROUND

California has five types of economic development areas that have similar tax incentives:

- Enterprise Zones,
- Los Angeles Revitalization Zone (LARZ),
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA)

### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <input checked="" type="checkbox"/> PENDING

### Department Director

### Date

Gerald H. Goldberg

8/27/98

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LARZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	X	
Hiring Credit	X	X	X	X	X
Construction Hiring Credit		X			
Employee Wage Credit	X				
Business Expense Deduction	X	X	X	X	
Net Interest Deduction	X	X			
Net Operating Loss	X	X	X	X	

\* NOTE: the LARZ expires December 1, 1998.

#### SPECIFIC FINDINGS

**Under the Government Code, existing state law** allows the governing body of a city or county to apply for designation as an enterprise zone. Using specified criteria, the Trade and Commerce Agency (TCA) designates enterprise zones from the applications received from the governing bodies. Enterprise zones are designated for 15 years and TCA has designated each of the 39 enterprise zones authorized under existing law.

**Under the Revenue and Taxation Code, existing state law** provides special tax incentives for taxpayers conducting business activities within an enterprise zone. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. In addition, a wage credit may be claimed by specified employees of businesses operating within an enterprise zone. See attachment A for a detailed discussion of each tax incentive.

**This bill** would require TCA to designate a portion of McClellan Air Force Base as an extension of the Northgate Enterprise Zone with a connecting corridor between it and the existing Northgate Enterprise Zone. The designation would be binding for 15 years. All tax incentives available to enterprise zones would be available to businesses operating in the expanded portion of the Northgate Enterprise Zone.

**This bill** would, in the Government Code, add to the definition of "qualified employee" for purposes of the hiring credit civilian employees of the Department of Defense employed at McClellan Air Force Base who were displaced or subject to a reduction in force notice. Additionally, **this bill** would repeat within the Government Code other criteria regarding individuals who are "qualified employees" for purposes of the hiring credit.

#### Implementation Consideration

Implementing this bill would occur during the department's normal annual system update.

#### FISCAL IMPACT

##### Departmental Costs

This bill would not significantly impact the department's costs.

### Tax Revenue Estimate

Revenue losses of this bill are estimated as follows:

Estimated Revenue Impact of SB 974 As Amended August 13, 1998 (In Millions)		
1998-9	1999-0	2000-1
Minor Loss *	(\$3)	(\$4)

\* Less than \$500,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Estimate Discussion

Revenue losses under the PITL and the B&CTL would depend on the number of businesses that would purchase qualified property subject to the sales or use tax, the amount of wages paid to qualified employees, and the state tax liabilities of employers claiming tax benefits.

Revenue loss projections are based on experience with similar types of tax incentives. Information received from area representatives and newspaper publications indicate, however, that the business potential for this area would be greater.

#### **Sales or Use Tax Credit**

The average sales or use tax rate for California is 7.92%. For every \$100 million in qualified property of which one-fourth of the calculated credit could be used to offset apportioned tax liabilities for the first year of designation, the revenue loss would be \$2 million and increasing thereafter.

#### **Hiring Credit**

Assuming an average wage of \$6.37 per hour, for every 1,000 employees that work an average of 2,000 hours and qualify employers for the first year credit, the revenue loss would be \$1 million (assuming 25% of calculated credits could be used to offset apportioned tax liabilities). It is anticipated that, because this bill includes individuals who were civilian employees at McClellan, the number of employees qualifying would be higher than would be expected for other enterprise zones.

#### **Expense Deduction**

The loss would probably be minor due to the limitation on the amount of expensing. For larger equipment many taxpayers would continue to use depreciation rather than this bill's expense option.

### **Net Operating Loss Deduction**

The revenue loss for the 100% net operating loss deduction option applied against income attributable to this project (rather than applying current law net operating loss provisions) probably would be rather minor in the first few years, less than \$1 million. This estimate is based on current law experience for enterprise zones and law changes that now permit small and new businesses to use 100% net operating loss deduction.

### BOARD POSITION

Pending.

Senate Bill 974  
Amended August 13, 1998  
Attachment A

**Enterprise Zone Sales or Use Tax Credit**

The enterprise zone sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an enterprise zone. The amount of the credit is limited to the tax attributable to enterprise zone income. Qualified machinery is defined as machinery and machinery parts used to (1) manufacture, process, combine, or otherwise fabricate a product; (2) produce renewable energy resources; or (3) control air or water pollution. In addition, qualified machinery must be purchased and placed in service before the enterprise zone designation expires. The maximum value of property that may be eligible for the enterprise zone sales or use tax credit is \$1 million for individuals and \$20 million for corporations.

**Enterprise Zone Hiring Credit**

A business located in an enterprise zone may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated an enterprise zone and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the enterprise zone and at least 50% must be performed inside the enterprise zone. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on enterprise zone income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage. The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

**Enterprise Zone Business Expense Deduction**

A business located in an enterprise zone may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the enterprise zone. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after designation	Maximum deduction
0 to 24	\$40,000
25 to 48	30,000
48 and over	20,000

### **Enterprise Zone Net Operating Loss Deduction**

A business located in an enterprise zone may elect to carry over 100% of the enterprise zone net operating losses (NOLs) to deduct from enterprise zone income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the enterprise zone.

### **Enterprise Zone Net Interest Deduction**

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone and the lender may not have equity or other ownership interest in the enterprise zone trade or business.

### **Enterprise Zone Employee Wage Credit**

Certain disadvantaged individuals who are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer's entire taxable income.

### **Apportioning**

For businesses operating inside and outside an enterprise zone, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax or income attributable to the enterprise zone. For businesses operating in an enterprise zone, income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the enterprise zone using a two factor formula based on the property and payroll of the business. This apportionment formula, which recently was enacted by AB 2798 (Stats. 1998, Ch. 323) differs from the prior formula in that the prior formula did not first apportion to California and then to the enterprise zone. Thus, the denominator for the prior apportionment formula was world-wide income whereas the new denominator is California income.

